

# Economic Update

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Volume 1, Number 2

14 June 2002

## Moderate Growth Projected; Jobs Show Modest Increase

The United States economy is growing at a moderate pace following the initial sharp rebound early this year from last year's recession. Although preliminary data put growth in real gross domestic product [GDP] in the first quarter at a 5.6 percent annual rate (up from 1.7 percent in the fourth quarter), the underlying rate of growth is lower. This is because much of the jump in growth can be attributed to a sudden cessation of inventory liquidation on the part of the Nation's businesses. Private forecasters – as represented by the Blue Chip Consensus – now project real GDP to grow in the range of about 3 percent to 3¼ percent at an annual rate for the remainder of this year and through 2003.

**Blue Chip Economic Outlook, June 2002**

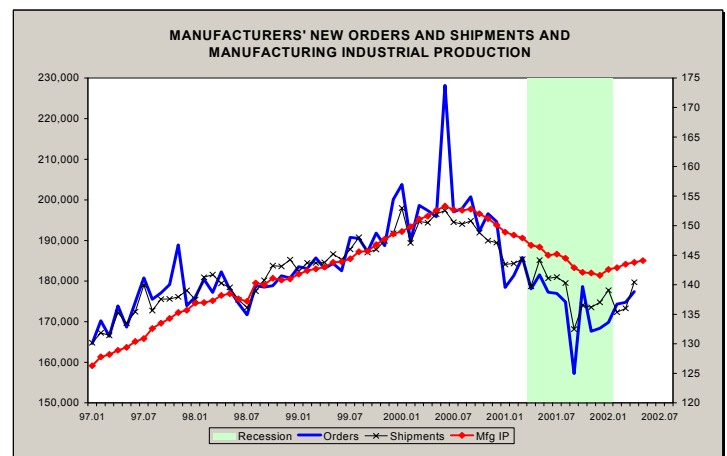
	2002.2	2002.3	2002.4	2003 Avg.
	(percent)			
Real GDP Growth	2.9	3.4	3.7	3.6
Unemployment Rate	6.0	5.9	5.8	5.5
CPI Inflation	3.4	2.2	2.3	2.5
3-month Treasury Bill	1.8	2.0	2.5	3.5
10-year Treasury Note	5.2	5.3	5.5	5.8

### Signs of Moderate Growth

**Employment:** Because GDP growth is expected to be at or only slightly above the economy's non-inflationary, "potential" growth rate – which most forecasters put in the 3-percent to 3½-percent range – improvement in labor markets and employment could be slow. The employment

report for May showed modest evidence of improvement: the unemployment rate for May was 5.8 percent (down from April's 6.0 percent), and the preliminary data on nonfarm payroll employment – perhaps the single most important indicator of the economy's current performance – showed a modest increase of 41,000 jobs. Generally, the labor situation has changed little over the past several months. Nevertheless, recent reports showing that initial claims for unemployment insurance fell sharply in the beginning of June were good news; the last time claims were lower was at the beginning of the recession in March 2000.

**Manufacturing and Investment:** Much of the decline during the recession was concentrated in manufacturing and in business investment, and the recovery now shows growing evidence of a nascent rebound in those areas. The Institute for Supply Management's purchasing managers' index – a key measure of the performance of the manufacturing sector

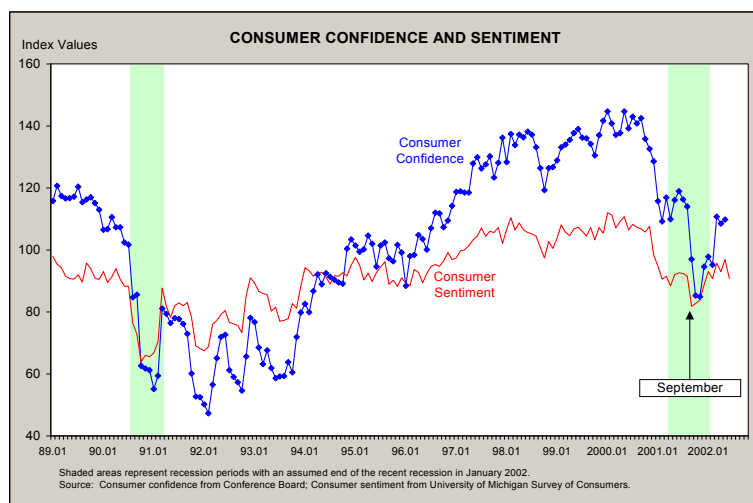


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– increased to 55.7 in May (a reading above 50 indicates an expanding manufacturing sector), its highest level in more than 2 years and up from a low of 39.5 during the recession in October 2001. Manufacturing industrial production and orders and shipments for manufacturer’s durable goods have been trending up since their recession lows in the latter months of 2001 (see chart on previous page). Shipments of computers and electrical equipment, in particular, have increased in recent months following dramatic declines during 2001. These and other incoming data suggest a possible return to growth in real fixed business investment in the second quarter, which would be the first increase in a year-and-a-half. At a minimum, the data indicate the large declines in business investment are over.

*Consumption and Residential Investment:* Initial data for the second quarter indicate that personal consumption spending – about two-thirds of all spending in the economy – is growing at a much slower pace than in recent quarters. Consumer confidence and sentiment have rebounded from their recession lows, but preliminary data for June show a slip in sentiment (see chart below). Also, advance data show that retail sales fell in May following gains in April, suggesting slow growth for the quarter. Residential investment appears likely to continue at relatively high levels, though it may pull back a bit from the good-weather-induced surge in the first quarter of this year. Continued upward trends in residential investment and house prices over the past 2 years have provided notable support for household wealth, bolstering consumption spending and keeping the recession from being more severe.



*Financial Markets:* Although financial market signals can be volatile, recent information suggests slower growth in the economy than anticipated earlier. By early June, broad stock market indexes were down more than 10 percent from the levels of earlier this year. Longer-term interest rates also have declined, with 10-year Treasury note yields falling from around 5.4 percent 2 months ago to below 5 percent recently – suggesting little danger of excessive acceleration in real growth and underlying inflation pressures. In addition, the foreign exchange value of the dollar has declined by about 6 percent to 8 percent from earlier this year against the Euro and a broader basket of major currencies. Still, the recent declines in the exchange value of the dollar represent only a small retreat from a decade-and-a-half high valuation, so the dollar remains relatively strong.

In combination, these relationships suggest a slower economy than previously anticipated, and an outlook for the Federal Reserve to keep interest rates low to bolster the economic expansion.

## The Tax Revenue Surprise

Despite the better than expected economic performance early this year, incoming data on Federal tax receipts indicate that a large unexplained shortfall for receipts is occurring this fiscal year. Much of this unexpected shortfall likely is the result of reduced tax liability and payments associated with last year’s recession. Such tax revenue surprises are not unusual when the economy experiences a sudden change, and particularly around “turning points,” when the economy is in a recession. Large unexpected “technical” shortfalls for tax receipts (shortfalls not explained by economic assumptions or policy changes) also occurred in fiscal years 1990, 1991, and 2001, when the economy also was in recession.

One thing is certain: the unexplained shortfall this year is not the result of policy changes – policy effects already were accounted for – but rather results from factors beyond the immediate control of policymakers. For example, Internal Revenue Service data show that in 1999, the top 1 percent of all tax filers paid 36 percent of all personal income taxes, and the top 5 percent paid 55 percent of income taxes. The heavy reliance on a small share of taxpayers for the bulk of personal income tax payments – and the volatility of that group’s income around economic turning points – produce volatility in tax receipts that leads to such surprises.